SETTLEMENT AGREEMENT

This Settlement Agreement ("Agreement") is made by San Diego Gas & Electric Company ("SDG&E") and the California Public Utilities Commission (the "Commission"), a public agency created by the California Constitution (hereafter collectively referred to as "the Parties") in resolution of the lawsuit filed by SDG&E in United States District Court for the Southern District of California.

RECITALS

A. In late 1996 and early 1997, SDG&E entered into power purchase contracts as follows: (1) with Illinova Power Marketing, Inc. ("Illinova") for 275 MW for 1997 and 200 MW for 1998 and 1999; (2) with Louisville Gas & Electric Energy Marketing ("LG&E") for 100 MW and 50 MW for 1998 through 2001 (LG&E later assigned its obligations to Avista Energy); and (3) with PacifiCorp for 100 MW for 1998 through 2001. These contracts are collectively referred to as the "Intermediate-Term Contracts."

B. From the start of the California restructured electricity market in April 1998 through February 1999, SDG&E recorded profits earned on the Intermediate-Term Contracts in its Transition Cost Balancing Account ("TCBA"). SDG&E's testimony in its 1998 Annual Transition Cost Proceeding ("ATCP") application described the Intermediate-Term Contracts. For the record period in the 1998 ATCP filing (January-June 1998), SDG&E recorded a net profit of approximately $1.8 million from these contracts in the TCBA. In its audit of the TCBA, Energy Division identified that the Intermediate-Term Contracts had been entered into after the AB 1890 cut-off date for power purchase contracts eligible for entry into the TCBA, December 20, 1995. Accordingly, SDG&E removed the net profits from the Intermediate-Term Contracts from the TCBA. The Office of Ratepayer Advocates ("ORA") performed its own audit of SDG&E's 1998 TCBA, including a review of the Energy Division audit. ORA disputed certain entries to the Generation Capital Additions Memorandum Account, employee transition costs and

post-retirement benefits other than pensions. Ultimately, ORA and SDG&E reached a settlement in the 1998 ATCP that addressed ORA's concerns. On February 17, 2000, the Commission issued D.00-02-048, approving ORA's and SDG&E's settlement of the disputed TCBA issues, and closing the 1998 ATCP. D.00-02-048 did not explicitly address the ownership of the Intermediate-Term Contracts.

C. In March 1999, SDG&E made an entry to its TCBA reversing the recording of profits from the Intermediate-Term Contracts through January 1999. SDG&E did not record any further profits from these contracts in the TCBA. As part of its audit of SDG&E's ATCP application that covered the record period July 1, 1998 through June 30, 1999 (A.99-09-011), ORA reviewed this adjusting entry. ORA "found SDG&E's entries in . . . the Transition Cost Balancing Account reasonable and supported," and ORA recommended no adjustments to SDG&E's TCBA. On October 23, 2000, the Commission issued D.00-10-048, finding SDG&E's entries to the TCBA for July 1, 1998 through June 30, 1999 to be reasonable, and adopting them with only a small disallowance related to employee transition costs. D.00-10-048 closed the 1999 ATCP. It did not explicitly address the ownership of the Intermediate-Term Contracts.

D. Pursuant to the rate ceiling enacted by AB 265 that specified the rate that SDG&E could charge its residential and small customers for the energy component of the electricity it sold, which ceiling was implemented by the Commission in D.00-09-040 (September 7, 2000), SDG&E accumulated an undercollection totaling hundreds of millions of dollars in a regulatory account originally called the Energy Rate Ceiling Revenue Shortfall Account ("ERCRSA"), a sub-account to the TCBA which is now called the Energy Revenue Shortfall Account ("ERSA"). AB 265 also specified that the SDG&E's revenues from the sales of energy from "utility-owned or managed generation assets" would be used to offset an under-collection**.**

E. On January 31, 2001, the Commission issued D.01-01-061, which, among other things, directed SDG&E and the other utilities to use all electricity resources under their control, also called "utility-retained generation," to serve existing customers at cost-based rates. The

portions of D.01-01-061 that are relevant to this Agreement became effective on February 1, 2001.

F. On February 16, 2001, SDG&E filed an application for rehearing of D.01-01-061, seeking clarification from the Commission that the term "utility-retained generation" did not include energy that SDG&E purchased through the Intermediate-Term Contracts.

G. On May 3, 2001, the Commission denied SDG&E's application for rehearing in D.01-05-035. As part of that decision, the Commission stated that SDG&E was obligated to provide the electric power from the Intermediate-Term Contracts to serve California customers as the Commission had ordered in D.01-01-061, and confirmed its order that the energy from the contracts be sold to ratepayers at cost-based rates.

H. On June 5, 2001, SDG&E filed a Petition for Writ of Review of D.01-01-061 and D.01-05-035 in the Court of Appeal of the State of California, Fourth Appellate District, Division One (the "Writ Petition"). In the Writ Petition, SDG&E asked the Court of Appeal to issue a peremptory writ of mandate directing the Commission to correct D.01-01-061 and D.01-05-035 to specify that the Intermediate-Term Contracts are the property of SDG&E's shareholders and may not be taken to serve SDG&E's retail customers at cost. While apprising the California Court of Appeal of the existence of SDG&E's federal claims, SDG&E expressly reserved the determination of those claims to a federal adjudication.

I. On June 18, 2001 SDG&E and the State of California, through the Department of Water Resources ("DWR"), entered into a Memorandum of Understanding ("MOU") for the elimination of SDG&E's AB 265 undercollection without increasing SDG&E's base electric rates. One of the primary elements in the MOU was the settlement of SDG&E's Writ Petition at the Court of Appeals ("Proposed CPUC Settlement Agreement"). This settlement would have required, among other things, SDG&E's shareholders to contribute $219 million towards elimination of the AB 265 undercollection, while affirming that the Intermediate-Term Contracts

were shareholder assets. Ultimately, the Commission chose to reject that settlement in January 2002.

J. On February 25, 2002, SDG&E filed a complaint in the United States District Court for the Southern District, Case Number 02CV339 BTM (LAB), for Declaratory and Injunctive Relief (the Federal Lawsuit) against Loretta M. Lynch, Richard A. Bilas, Henry M. Duque, Carl W. Wood, and Geoffrey F. Brown, in their official capacities as Commissioners of the Commission. The complaint alleges that the Commission's decisions D.01-01-061 and D.01-05-035 constitute an unconstitutional taking, violate the Commerce clause, are preempted by Federal law, and are a violation of substantive and procedural due process.

K. The issues raised by SDG&E in the Federal Lawsuit revolve around whether or not the Intermediate-Term Contracts are shareholder assets.

L. Notwithstanding this dispute, the ratepayers of SDG&E have already received a direct benefit of at least $175 million from the Intermediate-Term Contracts, because in D.01-01-061 and D.01-05-035 the Commission ordered SDG&E to sell the power from the Intermediate-Term Contracts to SDG&E's ratepayers at their actual cost, rather than the market price, from February 1, 2001, through December 31, 2001. SDG&E complied with those orders and booked $175 million in profits that it accumulated for that time period as follows: $115 million to reduce the undercollection contained in the ERSA for small and residential customers, and $60 million to credit the TCBA attributable to large commercial and industrial (*i.e.*, ABX1 43) customers.

M. The $60 million that SDG&E credited to the TCBA attributable to large commercial and industrial customers was included in the sum that, in the Proposed CPUC Settlement Agreement, SDG&E would have credited to the AB 265 undercollection. Since the time when the Proposed CPUC Settlement Agreement was first submitted for consideration by the Commission, the TCBA attributable to large commercial and industrial customers has experienced an over-collection, and in Advice Letter 1405-E, submitted on May 10, 2002, SDG&E offered a mechanism for returning this over-collection to ratepayers.

N. In addition to the $175 million in actual profits from the Intermediate-Term Contracts that SDG&E has already booked for the benefit of ratepayers, during the period from June through December of 2001, it is SDG&E's view that the State of California and SDG&E's ratepayers received an additional indirect benefit of approximately $52 million, because SDG&E's MOU with DWR called for SDG&E to sell the power from the Intermediate-Term Contracts to DWR at a substantially higher price than the price mandated under AB 265. (In SDG&E's view, this benefit is potentially even greater, because under SDG&E's agreement with DWR, power from the contracts would have been sold at a price 15% below prevailing market prices, and if SDG&E could have sold the power into the open market, this indirect benefit to ratepayers is even greater.) However, implementation of this portion of the MOU required Commission approval, which was not granted. Hence, SDG&E sold the power from the contracts between June and December of 2001 to ratepayers at the price specified in AB 265. It is SDG&E's position that as a result of SDG&E's inability to implement this portion of the MOU, SDG&E did not realize $120 million in shareholder profits that it would have otherwise realized. SDG&E believes that this lost opportunity for SDG&E's shareholders was to the ultimate benefit of the state and SDG&E's ratepayers, who ultimately paid significantly less for the power in question.

O. Because the Commission's decisions that required SDG&E to book the profits from the Intermediate-Term Contracts did not take effect until February 1, 2001, SDG&E has, to date, retained the profits from these contracts for the period from April 1998 through January of 2001. The amount of these profits that SDG&E has, to date, retained include the following: $67 million for the period from April 1998, when SDG&E began taking power under the contracts, until June 2000, when AB 265 took effect, and $130 million for the period from June 2000 through January 2001.

P. Although SDG&E has retained, to date, $197 million in profits from the contracts, SDG&E has effectively foregone $100 million of these profits in connection with

another settlement approved by the Commission. In D.01-11-029, the Commission approved a settlement, offered by SDG&E and ORA, in the Third Annual Transition Cost Proceeding (A.00-10-008), under which SDG&E agreed to write down the AB 265 undercollection by $100 million. The specific issue resolved in that settlement was the reasonableness of SDG&E's energy procurement activities from July 1, 1999 through February 7, 2001. Although the issue of the treatment of the Intermediate-Term Contracts as utility-retained generation or as shareholder assets was before the same parties in other proceedings, this issue was not an explicit part of the settlement of A.00-10-008.

Q. The Commission's approval of the $100 million settlement in A.00-10-008 was just one of the "CPUC Implementing Decisions" required of the Commission as a result of the MOU between SDG&E and the State (through DWR). SDG&E's agreement to the settlement of A.00-10-008 for a $100 million write-off was part of the totality of agreements made in the MOU, which included, among other things, Commission approval of <u>all</u> "CPUC Implementing Decisions" specified in the MOU. Thus, in the view of SDG&E, its agreement to the settlement of A.00-10-008 had the effect of reducing its profits from the Intermediate-Term Contracts by $100 million even though the terms of the settlement in A.00-10-008 did not state that the profits from the contracts would be the source of these funds.

R. Because SDG&E, acting in compliance with the Commission's decisions, has already booked a substantial portion of the profits from the Intermediate-Term Contracts to offset the AB 265 undercollection and has booked another significant portion of said profits to credit the TCBA for large commercial and industrial customers, it would work a substantial hardship on all SDG&E customers if SDG&E were to prevail on the merits in the Federal Lawsuit. SDG&E believes that if it had not been restricted by the Commission's decisions in D.01-01-061 and D.01-05-035, and had it been able to sell the power from the contracts on the open market without any regulatory restriction, it would potentially have been able to recoup more than $350 million in profits from the contracts for the period from February through December 2001.

S. Similarly, because SDG&E has to date retained a significant portion of the profits from the Intermediate-Term Contracts for the benefit of its shareholders, it would work a substantial hardship on SDG&E and its shareholders if the Commission were to prevail on the merits in the Federal Lawsuit. In such event, the Commission would potentially be entitled to recoup up to the full $197 million in profits that SDG&E has, to date, retained.

T. The Parties agree that the costs and risk of further litigation in the Federal Lawsuit is not in the public interest. Accordingly, the Parties agree that a settlement of this dispute is in their mutual interests, in the interest of SDG&E's ratepayers, and in the public interest.

U. The Parties further agree that the allocation to ratepayers of the $175 million that SDG&E has already booked to the benefit of ratepayers pursuant to Commission Decisions D.01-01-061 and D.01-05-035, plus the additional $24 million that SDG&E will book to the benefit of ratepayers pursuant to this Agreement, and the allocation to SDG&E's shareholders of the $173 million in profits from the contracts that SDG&E has retained, represent a fair and reasonable apportionment of the litigation risk that the Parties respectively bear in the Federal Lawsuit.

V. The Commission is entering into this Agreement in the exercise of its police and regulatory power. The Commission has the authority to settle the Federal Lawsuit on behalf of the Commissioners who are sued in their official capacities, and subsequent to the approval of this Agreement by a majority vote of the Commission, the Commission's General Counsel will have the authority to execute this Agreement on behalf of the Commission.

W. It is the view of SDG&E that the approval of this Agreement by the Commission does not require either of the Commission's underlying decisions, D.01-01-061 and D.01-05-035, to be rescinded, altered or amended in any way. This is because SDG&E has complied with the requirements of those decisions, insofar as they affect SDG&E's accounting treatment of the Intermediate-Term Contracts, even though SDG&E did not agree with said decisions and has challenged those decisions in the Federal Lawsuit, the settlement of which is the subject of this

Agreement. By their own terms, the portions of D.01-01-061 that are relevant to this Agreement became effective on February 1, 2002, and the effect of D.01-05-035 was to confirm the applicability, from February 1, 2001 forward, of the Commission's ordering language in D.01-01-061 to the Intermediate-Term Contracts. The adoption by the Commission of D.01-01-061 and D.01-05-035 did not affect, or purport to affect, SDG&E's accounting treatment of the Intermediate-Term Contracts for the period of time prior to January 31, 2001, the date on which the Commission adopted the first of those decisions.

X. The Parties agree that once this settlement is approved, the ERSA balance as of April 30, 2002 will be $301 million.

NOW, THEREFORE, in consideration of the mutual promises contained herein, SDG&E and the Commission agree as follows:

AGREEMENT

1. SDG&E agrees that, on the Effective Date (as defined below), it will write-off, and not collect from customers, an additional $24 million of the current balance in SDG&E's ERSA.

2. For purposes of this settlement and for all ratemaking and accounting purposes, the Parties agree that the $173 million of the profits from the Intermediate-Term Contracts that SDG&E accrued prior to the adoption by the Commission of D.01-01-061, and that will remain with SDG&E after the Effective Date of this Agreement, are the property of SDG&E for the sole account of its shareholders, and that the $199 million in profits from the Intermediate-Term Contracts that SDG&E has booked since the adoption by the Commission of D.01-01-061, or will book pursuant to this Agreement, to the benefit of ratepayers will remain with ratepayers.

3. SDG&E agrees to withdraw and dismiss all legal challenges to the Commission's D.01-01-061 and D.01-05-035 following a final non-appealable stipulated judgment approved and entered by the District Court as provided in paragraph 6.

4. This Agreement shall be effective upon its execution by SDG&E and the Commission. The date upon which both parties have duly executed this Agreement is referred to as the "Effective Date."

5. The Commission agrees to take all action necessary to implement and be consistent with this Agreement and to forbear from taking any action inconsistent with this Agreement.

6. Within five (5) days of the Effective Date, the parties shall submit to the United States District Court a proposed stipulated judgment that shall incorporate this Agreement by reference and order the terms of this Agreement to be entered as the judgment of the Court. The parties shall undertake their best efforts to seek entry by the Court of the stipulated judgment within thirty (30) days after the Effective Date. The parties agree that the Court shall retain jurisdiction for the purpose of enforcing the stipulated judgment and ensuring that the parties carry out the terms of this Agreement. The parties and their respective successors and assigns agree not to contest the validity and enforceability of this Agreement or the stipulated judgment as agreed to by the parties and entered by the Court. This Agreement and the stipulated judgment are intended to be enforceable under federal law, notwithstanding any contrary state law.

7. The Commission agrees to cooperate with SDG&E and to support the continuance of the stay issued by the California Court of Appeal pending approval of this settlement and the successful resolution of any challenge to this Agreement by any non-party. Following approval by the District Court and the successful resolution of any challenge by any non-party, counsel for SDG&E shall take such steps as are necessary to dismiss the Writ Petition with prejudice. If necessary, counsel for the Commission shall cooperate in any California Court of Appeal dismissal.

8. This Agreement reflects a settlement of disputed issues of fact and law. It does not constitute an admission by either SDG&E or the Commission of wrongdoing with respect to any matter or thing.

9. For good and valuable consideration, SDG&E does hereby forever release, discharge and acquit the Commission, the State of California, and their respective agencies, departments, subdivisions, successors, officials, agents, representatives, employees and each of them from any and all claims, demands, obligations, liabilities, indebtednesses, acts omissions, misfeasance, malfeasance, cause or causes of action, debts, sums of money, accounts, compensation, controversies, promises, damages, costs, losses and expenses (including but not limited to attorneys' fees), of every type, kind, nature, description or character, and irrespective of how, why, or by reason of what facts, whether heretofore, now existing or hereafter arising, or which could, might or may be claimed to exist, of whatever kind or name, whether know or unknown, suspected or unsuspected, liquidated or unliquidated, each as though fully set forth herein at length, that arise from or in connection with: (a) the facts pled, or that could have been pled in the Federal Lawsuit, including without limitation, claims and causes of action based on takings of these Intermediate-Term Contracts under the California and United States Constitutions or which in any way arise therefrom or relate thereto; and (b) the issuance by the Commission of its decisions D.01-01-061 and D.01-05-035. SDG&E agrees, represents and warrants that the matters released herein are not limited to matters which are known or disclosed and SDG&E hereby knowingly and specifically waives any and all rights and benefits which it now has, or in the future may have, conferred upon it by virtue of the provisions of Section 1542 of the Civil Code of the State of California which provides as follows:

> **A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the debtor.**

In this connection, the Parties hereby agree, represent and warrant that they have read and understand this Agreement. SDG&E acknowledges that factual matters now unknown to it may have given or may hereafter give rise to causes of action, claims, demands, debts, controversies, damages, costs, losses and expenses which are presently unknown, unanticipated and

unsuspected, and SDG&E further agrees, represents and warrants that this release has been negotiated and agreed upon in light of that realization and that it nevertheless hereby intends to release, discharge and acquit the parties hereinabove from any such unknown causes of action, claims, demands, debts, controversies, damages, costs, losses and expenses. SDG&E further agrees, represents and warrants that it is the owner of and has not transferred, assigned or hypothecated any of the claims, rights, demands and causes of action released herein, and no other person or entity owns, holds or has any interest in the claims, rights or causes of action released herein.

10. SDG&E and the Commission declare and represent that no promise, inducement or other Agreement not expressly contained herein has been made conferring any benefit upon any party. SDG&E and the Commission further declare and represent that this Agreement contains the entire agreement of the Parties pertaining to its subject matter and supersedes any prior or contemporaneous negotiations, representations, agreements, and understandings of the parties with respect to such matters, whether written or oral. SDG&E and the Commission acknowledge that they have not relied on any promise, representation or warranty, expressed or implied, not contained in this Agreement. Parol evidence shall be inadmissible to show agreement by and among the Parties to any term or condition contrary to or in addition to the terms and conditions contained in this Agreement.

11. This Agreement is made under and will in all respects be interpreted, enforced and governed by the laws of the State of California. The Agreement cannot be altered, amended or modified in any respect, except by a writing duly executed by the party against whom the alteration, amendment or modification is charged, specifically referring to this Agreement.

12. This Agreement may be executed in counterpart and has the same force and effect as if all the signatures were obtained in one document.

13. The language used in this Agreement shall be deemed to be the language chosen by SDG&E and the Commission to express their mutual intent, and no rule of strict construction

shall be applied against the other. The language of all parts of this Agreement shall be construed as a whole, according to fair meaning. SDG&E and the Commission agree that the drafting and negotiating of this Agreement has been participated in by each, and for all purposes this Agreement shall be deemed created by all.

14. If any term or other provision of this Agreement is invalid, illegal or incapable of being enforced by any rule of law, all other conditions and provisions of this Agreement shall nevertheless remain in full force and effect to the extent the overall integrity and intent of this settlement is maintained.

15. Nothing in this Agreement shall entitle any party other than the Commission and SDG&E and their authorized successors and assigns to any claim, cause of action, remedy or right of any kind.

SAN DIEGO GAS & ELECTRIC COMPANY

By: _____ Dated:
Edwin A. Guiles
Chairman & CEO
Sempra Energy utilities

CALIFORNIA PUBLIC UTILITIES COMMISSION

By: _____ Dated:
Gary M. Cohen, General Counsel